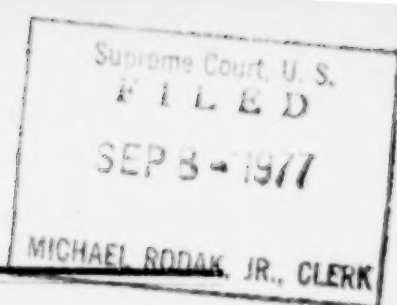


No. 77-35



In the Supreme Court of the United States

OCTOBER TERM, 1977

IRWIN DONALD KIRSCHENBLATT, A/K/A DONALD KIRSCH,
AND ARTHUR SCHEVACK, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE
SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE
COMMISSION IN OPPOSITION

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OPINIONS BELOW

The court of appeals rendered no opinion. The opinion of the district court (Pet. App. A)¹ is reported at 417 F. Supp. 1225.

JURISDICTION

The judgment of the court of appeals was entered on April 7, 1977 (Pet. App. C). The petition for a writ of certiorari was filed on July 5, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

¹"Pet." refers to the petition, "Pet. App." to the petition's appendices, and "App." to the joint appendix in the court of appeals, a copy of which has been lodged with the Clerk.

QUESTION PRESENTED

Whether the "field manager" and "distributorship" interests offered and sold to the public by Galaxy Foods, Inc. were securities, subject to the registration and anti-fraud provisions of the federal securities laws.

STATUTES INVOLVED

Relevant provisions of the Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. 77a, *et seq.*, and the Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. 78a, *et seq.*, are set forth in Pet. App. D.

STATEMENT

Galaxy Foods, Inc. was founded in 1971 by three individuals who contributed \$100 in capital (App. 1997-2000, 2005). Galaxy raised more than \$2.4 million by offering and selling as investments (App. 281, 1841-1843, 1847-1848, 1856, 1873, 1888-1889),² more than 800 "franchises" called "field manager positions" and "distributorships," at prices ranging between \$1,000-\$3,000 and \$3,000-\$7,000, respectively (App. 280-281, 1759, 1773-1774).

Purchasers were promised, and received, commissions for "bringing in" (App. 280) new investors (App. 1760-1761, 1842-1843, 1847-1849). But the purchasers themselves were not to make sales to new investors. Rather, they were merely to attempt to persuade "prospects" to attend "opportunity meetings" held by Galaxy and were told to give their prospects little, if any, information about Galaxy itself. (App. 297-298, 1761-1764, 1771-1792.)

²A chart prepared by Galaxy titled "WHAT IS THE BEST WAY FOR YOU TO PUT YOUR MONEY TO WORK FOR YOU" contrasted, as a "type of investment," a \$5,000 Galaxy distributorship with a \$5,000 investment in a savings bank, securities or real estate, and asserted that the interest in Galaxy would give the best "RETURN ON YOUR INVESTMENT" (App. 1873).

From a script Galaxy prepared, speakers at these "opportunity meetings" explained how an investor in Galaxy purportedly could receive as much as \$60,000 per year within three months after purchasing a "field manager" or "distributorship" interest (App. 305-311, 1761-1762, 1839-1841, 1844). If a prospect did not succumb during the "opportunity meeting," the prospect would be invited to a "Sunday step-up meeting" (App. 297), where Galaxy's management intentionally created "a high-pressure atmosphere" (Pet. App. A 15) designed to imbue the prospects "with an almost irrational desire to [invest in Galaxy]" (Pet. App. A 15).³

In addition to commissions on sales of additional "field manager positions" and "distributorships," purchasers also were promised commissions on Galaxy's proposed retail sales of food and other supermarket items (App. 1839-1842, 1847-1849).⁴ Galaxy claimed that purchasers could "earn large sums of money merely by recruiting salesmen and having them introduce our service to customers" (App. 1836). Galaxy promised that it would train these salesmen, provide them with a local telephone number for their customers to call, and that, thereafter, Galaxy would take the customers' telephone orders from

³Galaxy's organization, its commission structure, and its promotional efforts, especially the "opportunity meetings," were patterned after a pyramid promotion enterprise operated by Koscot Interplanetary, Inc. See *Securities and Exchange Commission v. Koscot Interplanetary, Inc.*, 497 F. 2d 473 (C.A. 5). Galaxy's founders and the petitioners in this Court had formerly been associated with Koscot (App. 1757, 1775, 1781).

⁴Galaxy's retail sales occurred only during a four month "pilot program," which resulted in a net loss of approximately \$40,816. The cost of the goods purchased for the program was over \$201,630 and the gross proceeds from the sale of these goods totaled approximately \$160,814 (Pet. App. A 23).

the Galaxy catalogue and would deliver their purchases, in Galaxy's trucks and from its own warehouses. The salesmen were not to be required to reservice or even recontact the customers. Nevertheless, purchasers who recruited salesmen, as well as the salesmen themselves, were promised commissions on any orders placed by customers whom the salesmen originally contacted (App. 1771-1772, 1836-1842).

In November 1973, the Securities and Exchange Commission filed a complaint in the United States District Court for the Eastern District of New York seeking injunctive and other equitable relief against petitioners and eight other defendants.⁵ It alleged that Galaxy's operation involved the offer and sale of securities in violation of the registration and anti-fraud provisions⁶ of the federal securities laws (Pet. App. A 3a-27a).

The district court found that the "field manager positions" and "distributorships" were securities within the meaning of Section 2(1) of the Securities Act of 1933 and Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 77b(1) and 78c(a)(10), and not traditional franchises, because the purchasers were not significantly involved in Galaxy's operations; they were passive investors

⁵Consent decrees were entered against six of the other defendants prior to trial. During the trial, which lasted eight days, the sole remaining individual defendant, in addition to petitioners, also consented to the entry of a decree. (App. 1757-1758.) Prior to trial, the corporate defendant, Galaxy Foods, Inc., filed a voluntary petition in bankruptcy and the action was stayed as to it (App. 1774).

⁶Section 5 of the Securities Act of 1933, 15 U.S.C. 77e; Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5.

in the firm's promotional and retailing scheme (Pet. App. A 33-39). It ruled that Galaxy's management, not the "franchisees," actually sold additional "field manager positions" and "distributorships"; the "franchisees" were merely to "whet a prospect's appetite sufficiently to lure him or her to an Opportunity Meeting" (Pet. App. A 35). It was for this limited participation that the investors received commissions (Pet. App. A 35-36).

Similarly, with respect to Galaxy's proposed retail sales operation, the district court found that investors were merely "to hire salespeople" who "were in reality employees of Galaxy, which was to register them, train them and pay them" (Pet. App. A 37). Investors then would receive commissions on retail sales made by those salespeople—sales which were dependent upon "Galaxy's order-taking, warehousing, packaging, weighing, cutting and delivering services" (Pet. App. A 38).

The district court permanently enjoined petitioners from further violations of the registration and anti-fraud provisions of the federal securities laws, and ordered petitioner Kirschenblatt to make restitution of \$3,700 and petitioner Schevack to make restitution of \$8,250 (Pet. App. B).

The court of appeals affirmed without opinion (Pet. App. C).

ARGUMENT

The courts below correctly held that the interests in Galaxy offered and sold by petitioners were investment contracts and, therefore, securities within the meaning of Section 2(1) of the Securities Act of 1933 and Section 3(a)(10) of the Securities Exchange Act of 1934.

The term "security" must be applied in the light of business realities and the "statutory policy of affording broad protection to investors." *Securities and Exchange*

Commission v. Howey, 328 U.S. 293, 301. In *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852, this Court observed that: "[t]he touchstone [of the Court's decisions defining 'security'] is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."⁷

The only other courts of appeals applying this standard to pyramid promotion schemes like that involved here have reached the same result as the courts below. *Securities and Exchange Commission v. Koscot Interplanetary, Inc.*, 497 F. 2d 473 (C.A. 5); *Securities and Exchange Commission v. Glenn W. Turner Enterprises, Inc.*, 474 F. 2d 476 (C.A. 9), certiorari denied, 414 U.S. 821. Three circuits have thus correctly held that performance by investors of minor services to aid a business scheme does not turn their interests into non-securities, so long as they provide the capital in expectation of sharing in the earnings and profits, and the significant entrepreneurial efforts are performed by the promoters and their successors through the management, control and operation of the enterprise. *Howey, supra*, 328 U.S. at 300.

Petitioners contend (Pet. 5-6) that the rulings of all three circuits are in conflict with *Howey, supra*, because the Court there defined an investment as (328 U.S. at 298-299): "[A] contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits

⁷See *Tcherepnin v. Knight*, 389 U.S. 332; *Securities and Exchange Commission v. United Benefit Life Insurance Co.*, 387 U.S. 202; *Securities and Exchange Commission v. Variable Annuity Life Insurance Co.*, 359 U.S. 65; *Securities and Exchange Commission v. Howey, supra*; *Securities and Exchange Commission v. C. M. Joiner Leasing Corp.*, 320 U.S. 344.

solely from the efforts of the promoter or a third party * * *." (Emphasis added.) We submit, however, that the qualification "solely" was simply a reference to the facts of the *Howey* case. The Court there held that interests in orange groves which were coupled with service contracts, were securities. It based its ruling on a record showing that no part of the entrepreneurial efforts were to be performed by the interest-holders. Thus, the Court in *Howey* did not consider or decide that if, as the district court here found (Pet. App. A 36), insignificant entrepreneurial efforts are performed by the interestholders, those interests fall outside the protection of the securities laws.

Petitioners also attempt to bring this case within the facts of *United Housing Foundation, Inc. v. Forman, supra*, by asserting that Galaxy's "franchises" were "motivated by a desire to use or consume the item purchased" (Pet. 7). But this assertion is contrary to the findings and the evidence. As the district court found (Pet. App. A 39; citation omitted):

In sum, prospective franchisees were being asked to invest substantial sums of money in Galaxy for which the essence of the consideration received was not products or otherwise useful training but simply the opportunity to earn money if the efforts of others, Galaxy's management and the salespeople, proved successful.^[8]

⁸Petitioners also claim that when the violations took place, no decision had treated their scheme as subject to the securities laws (Pet. 6). Since this case involves only prospective civil injunctive relief and limited restitution, they have no basis for complaint.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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SEPTEMBER 1977.